Hogan Lovells

Private Capital Insights

October 20, 2020

This is a commercial communication from Hogan Lovells. See note below.

Final regulations – U.S. withholding tax on transfers of partnership interests

Since 2018, the buyers, sellers, and partnerships engaging in secondary and other transactions involving partnership interest transfers have been navigating complicated U.S. tax and related withholding obligations that apply when a non-U.S. partner transfers an interest in a partnership that is engaged in a U.S. trade or business.

Recently, the U.S. Internal Revenue Service (IRS) issued final regulations under IRC Section 1446(f) that address the buyer/transferee's obligation to deduct and withhold tax arising from the transfer and that make effective (as of January 1, 2022) a secondary withholding tax obligation imposed on the partnership itself.

These final rules provide some needed flexibility but will continue to require significant attention of the parties in partnership interest transfer transactions to both manage withholding tax risk and minimize overwithholding. **These rules are relevant for both U.S. and non-U.S. partners buying from non-U.S. partners and are relevant for any partnerships, with or without a U.S. trade or business, that have (or may have) non-U.S. partners.**

Background

On October 7, 2020, the IRS issued final regulations (the Final Regulations) (T.D. 9926) under Section 1446(f) of the Internal Revenue Code of 1986, as amended (IRC), providing guidance on withholding and information reporting with respect to non-U.S. persons who dispose of an interest in a partnership engaged in a U.S. trade or business and recognize gain subject to tax under IRC Section 864(c)(8) as income effectively connected with that U.S. business (ECI). Final regulations under Section 864(c)(8) were issued on September 21, 2020 (see our prior alert here).

The Final Regulations address both publicly traded partnership (PTP) interests and non-publicly traded partnership (non-PTP) interests. This alert addresses only transfers of non-PTP interests.

For the most part, the Final Regulations adopt the basic structure and approach of the proposed regulations that were issued on May 13, 2019 (the Proposed Regulations) (see our prior alert here) but include certain revisions based on comments received.

The Final Regulations are generally applicable to transfers of non-PTP interests occurring on or after 60 days from publication of the Final Regulations in the Federal Register. The applicability date for partnership-level withholding obligations is delayed and applies to transfers of non-PTP interests on or after January 1, 2022, in order to give partnerships time to implement the withholding.

Certain key provisions are summarized below.

Clarifications to scope of withholding

The Final Regulations retain the general rule of the Proposed Regulations that withholding applies on the transfer of any partnership interest, unless an exception or adjustment applies. In response to comments that the Proposed Regulations were overly broad and could require withholding on the transfer of an interest in a partnership that has no U.S. assets or U.S. connections, the Final Regulations add two new provisions:

New "No U.S. trade or business" exception – No withholding is required under this new exception if the partnership certifies to the transferee that the partnership is not engaged in a trade or business within the U.S. at any time during the taxable year through the date of the transfer. This exception could apply, for example, to a partnership with entirely non-U.S. business assets, to a partnership that holds both non-

U.S. business assets and stock of a U.S. real property holding corporation (but no direct U.S. trade or business assets), or to a partnership that makes all its investments in U.S. trade or business assets through blocker corporations. Although the new exception is a favorable addition to the Final Regulations, its utilization may be dependent in a number of circumstances on the willingness of a partnership with limited U.S. connections to make a U.S. tax certification under penalty of perjury.

New modification to liability for failing to withhold – A transferee that fails to properly certify an exception or to properly withhold is generally liable for the unpaid withholding tax, interest, and potential penalties. The second new rule provides that if any person required to withhold under Section 1446(f) establishes to the satisfaction of the IRS that no gain on the transfer is subject to tax as ECI under Section 864(c)(8), that person will not be liable for failure to withhold, or any interest, penalties, or additions to tax. The modified liability rule also applies to the partnership with regard to its secondary withholding obligation. This new rule is also a favorable addition to the Final Regulations, although transferors and partnerships will likely remain incentivized to reduce uncertainty and qualify for a withholding exception that is not dependent on persuading the IRS at some unknown future time that the transfer did not give rise to ECI gain.

Final exceptions to withholding

The Final Regulations retain the six withholding exceptions included in the Proposed Regulations, with modifications to certain of them, and add the "no U.S trade or business" exception described above.

Thus, the final withholding exceptions are:

- *Non-foreign status* – The transferor certifies that it is not a foreign person.
- *No realized gain* – The transferor certifies that it will not realize any gain on the transfer, including any ordinary income arising under Section 751.
- *Less than 10 percent ECI* – The transferor certifies that, for each taxable year during a three-year lookback period, the distributive share of gross effectively connected income of the transferor (and any related partner) was less than US$1 million and less than 10 percent of its total distributive share of partnership gross income.
- *Nonrecognition transfer* – The transferor certifies that a nonrecognition provision applies to all of its gain on the transfer.
- *Treaty exemption* – The transferor certifies that a treaty exemption applies to all of its gain on the transfer.
- *Less than 10 percent ECI gain* – The partnership certifies that, if it sold all of its assets at fair market value on the determination date, either (a) the partnership would not have any effectively connected gain (EC gain) or the net amount of its EC gain would be less than 10 percent of the partnership's total net gain or (b) the transferor would not have a distributive share of net EC gain from the partnership or the transferor's distributive share of net EC gain from the partnership would be less than 10 percent of the transferor's distributive share of total net gain from the partnership.
- *No U.S. trade or business* – The partnership certifies that it was not engaged in a trade or business within the U.S. at any time during the taxable year of the partnership through the date of the transfer.

The determination date for the exceptions is generally the transfer date or any date within the prior 60 days. The exceptions are subject to satisfaction of various conditions. Where the partnership is the transferee, it may establish the exceptions based on its books and records.

The modifications to the exceptions by the Final Regulations include:

Non-foreign status exception – If a certification is not obtained, the preamble to the Final Regulations confirms that the transferee would be allowed under the modified liability rule to avoid liability for failing to properly withhold, provided the transferee can successfully demonstrate to the IRS that the transferor had no EC gain because it is not a foreign person.

No realized gain exception – The Final Regulations retain the rule that this exception is not available to a transferor that realizes ECI on the transfer by operation of Section 751, even if the transferor realizes an overall loss on the transfer.

10 percent ECI exception (transferor certification) – The Final Regulations modify this exception to refer to the transferor's distributive share of gross ECI (as reported on IRS Schedule K-1) and of partnership gross

income. A transferor that is not allocated any effectively connected income or loss in any relevant year may still use this exception even if it has not received an IRS Form 8805 for that year. A transferor will generally be able to use this exception even if it is allocated a distributive share of net loss from the partnership for the relevant year. However, a transferor cannot use this certification if it did not have a distributive share of gross income in each of the relevant years.

10 percent EC gain exception (partnership certification) – The Final Regulations modify this exception by allowing the partnership to make the relevant determination not only with regard to EC gain at the partnership level but, alternatively, with regard to the transferor's distributive share of EC gain. As modified, the exception applies to a transferor that would not have a share of EC gain, which may result in partnerships utilizing common structures involving blocker corporations to be able to provide this certification (assuming the partnership is otherwise willing to do so).

Disguised sales

The Final Regulations confirm that disguised sales of partnership interests are subject to Section 1446(f) withholding. Although requested by commenters, the Final Regulations did not provide an exception from withholding that would apply to common fund raising processes that involve multiple investor closings and could be characterized as disguised sales.

Determining the amount to withhold

If no exception to withholding properly applies, the transferee is generally required to withhold 10 percent of the transferor's "amount realized," which includes the purchase price (in cash or property) plus the reduction in the transferor's share of partnership liabilities. In determining the amount to be withheld, a transferee may rely on a properly completed certification from the transferor of its maximum tax liability (which is based on information provided to the transferor by the partnership).

The Final Regulations largely adopt the rules of the Proposed Regulations for determining the withholding amount but include a modification to allow for a reduction of the amount realized when the transferor is a non-U.S. partnership that has a direct or indirect partner that is not subject to tax on gain from the transfer pursuant to an applicable U.S. tax treaty.

Partnership-level secondary withholding

To the extent that the transferee fails to withhold the required amount on the transfer of a partnership interest, the partnership is required to deduct and withhold this amount (plus interest) from future distributions to the transferee. The Final Regulations largely adopt the rules of the Proposed Regulations regarding partnership-level secondary withholding and also confirm the broad discretion of the partnership in determining whether withholding is required.

Under the Proposed Regulations, the partnership may rely on a certification from the transferee that the underlying transfer qualified for a withholding exception or that the transferee had properly withheld on the amount realized, unless the partnership knows or has reason to know that the certification is incorrect or unreliable. The transferee must provide this certification to the partnership within 10 days of the transfer and deposit any required amount of witholding with the IRS within 20 days of the transfer.

The preamble to the Final Regulations confirms that the partnership is not required to rely on the transferee's certification and may withhold on a transferee that has fully complied with its withholding obligations whether or not the partnership knows or has reason to believe that the certification is incorrect or unreliable.

The preamble notes that the transferee can choose to withhold 10 percent of the amount realized on the transfer, consult with the partnership regarding the accuracy of the certification and, depending on the outcome of that consultation, within 20 days either repay the withheld amount to the transferor or deposit the withheld tax with the IRS.

Under the Final Regulations, the transferee, rather than only the partnership, may claim a refund of any overwithholding.

Information reporting between transferor and partnership

The Final Regulations adopt rules that require the exchange of information between the non-U.S. partner that is subject to tax under Section 864(c)(8) and the partnership whose interest is transferred. The transferor partner is required to notify the partnership of the transfer within 30 days. The partnership is obligated to provide the transferor partner with the information necessary for the partner to determine its

EC gain, including whether the transfer of the interest would result in any Section 751 ordinary income to the transferor. These requirements apply to transfers that occur on or after the date that the Final Regulations are published in the Federal Register.

Adjustments for the secondaries market

While market participants have had to navigate the withholding tax process involving non-U.S. partners for some time, these Final Regulations do represent a step change. While over time a market practice will arise, there is likely to be a period of adjustment and advanced preparation by sellers and buyers and early engagement with general partners will be well advised.

This Private Capital Insights is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed to the right.

Contributors

Nancy O'Neil
Partner, Baltimore, Washington, D.C.
T +1 410 659 2752 (Baltimore)
T +1 202 637 5734 (Washington, D.C.)
nancy.oneil@hoganlovells.com

Caitlin Piper
Senior Associate, Washington, D.C.
T +1 202 637 5415
caitlin.piper@hoganlovells.com

David Steenburg
Senior Associate, Washington, D.C.
T +1 202 637 6426
david.steenburg@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta *
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.
Zagreb*

*Our associated offices
Legal Services Centre: Berlin

www.hoganlovells.com